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OIL PRICING AND SECURITY:
A POLICY FRAMEWORK FOR CANADA



The Honourable William G. Davis
Premier of Ontario
August, 1979

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FOREWORD

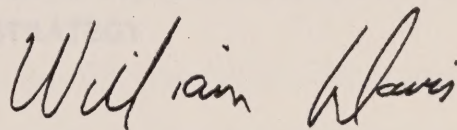
A fundamental review of Canadian energy policy is dictated by both domestic and international realities. Over the next few weeks, the Government of Canada will be reviewing the basis for a new national oil pricing and security policy.

On behalf of the people of Ontario, I am determined that the Government of Ontario participate in the development of a Canadian policy framework worthy of the decade ahead. To this end, a working committee of senior officials from the Ministry of Treasury and Economics, the Ministry of Energy, the Ministry of Industry and Tourism, and the Cabinet Office was asked to consider, and to promptly advise the Government on the impacts of possible oil price increases and appropriate policy responses. This document outlines the perspectives and the basic objectives the Government of Ontario will advocate in the crucial negotiations ahead.

Our duty is to represent the Province of Ontario to the best of our ability. Nevertheless, that can only be responsibly and successfully undertaken by considering the future of Canada as a whole. It is my hope that what we say regarding oil prices and development, energy security, and economic and fiscal policy reflects national circumstances and will assist all parties in finding co-operative and national solutions.

As we enter the 1980's, it is vital that Canada frame a working consensus on energy matters that has eluded us in this decade. Equally important, it is urgent to understand and address oil pricing as not simply an issue between buyers and sellers. The costs we pay and the ways we secure it will affect profoundly the safety of our economy, the vitality of our Confederation and the social and economic aspirations of Canadians everywhere.

This document outlines our views on some of the basic elements we need for securing a strong and united future. I hope it will be considered widely as we play our part in this vital national debate.



William G. Davis
Premier of Ontario

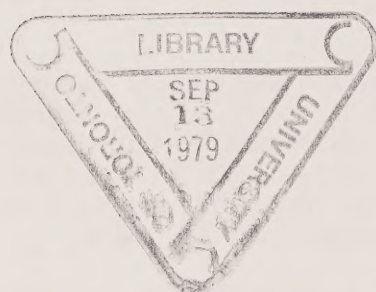


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I. CANADIAN OIL AND GAS PRICING

Ontario's Position

To a very real extent, crude oil must be seen as a commodity much the same as others in the market place. As a consuming province, it would be unfair and foolhardy for Ontario to deny the producers of oil a fair price and indeed, an increasing price, as supplies become more expensive to secure.

It is acknowledged that price does affect consumption and that oil consumption should be moderated. Nevertheless, the federal government and the producing provinces, which together capture about sixty per cent of the revenues from oil price increases, must continue to bear in mind that energy is, to a great extent, a public asset, which must continue to be priced in the public arena.

This nation must manage the domestic price of oil to reflect Canadian objectives. Canadian crude oil self-sufficiency is today a stated policy of the federal government and Ontario. If the nation is to bear the cost of oil independence, then it is only consistent that consumers enjoy the right to participate in setting independent Canadian crude oil prices.

Ontario has repeatedly expressed its concerns related to sharp increases in domestic oil prices. Particular emphasis has focussed on the adverse impacts on Canada's employment and inflation performance, and the long-run goals of balanced regional development. Also of primary concern has been the limited extent to which revenues flowing from price increases have been directed towards increasing Canadian oil supplies. It has consistently been Ontario's position that only by increasing Canadian crude oil independence can Canadians be shielded from the political and economic power of the OPEC oil cartel.

Ontario has advocated a national policy of achieving Canadian crude oil self sufficiency by 1995.

To meet these various concerns, Ontario has outlined a number of basic principles for crude oil pricing in Canada. Specifically, Ontario has contended, and continues to believe, that:

To minimize adverse short and long-run economic impacts:

- . *the world price should not be regarded as the target benchmark for pricing Canadian crude oil; and*
- . *Canadian prices should be below the average United States oil prices at Chicago.*

To maintain the goal of balanced regional growth:

- . *a single national price for oil should be maintained with allowance for transportation costs; and*


To encourage new supply:

- . *the domestic crude oil price should be cost related (for example, a blended price),* with the levels determined by the need to bring on new supplies.*

To encourage substitution of relatively abundant natural gas for crude oil:

- . *the price of natural gas should not be linked to crude oil prices at a high indexing level.*

* For a description of Ontario's blended price proposal see Appendix A.



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These policies, which have been advocated since 1974, have not been wholly adopted in price negotiations between the federal government and the producing provinces. The crucial principle of Canadians setting Canadian oil and gas prices, however, has won general support up to now. Consequently, to an important degree, the economies of the consuming provinces have avoided the unnecessary and arbitrary burden that would have been imposed by OPEC price setters. Nevertheless, Canadian oil and gas prices have escalated significantly. Also, there are not yet in place comprehensive economic measures to adjust, as a nation, to the price changes which have occurred or to what the future may hold.

Current Challenge

In 1974 Canadian oil prices jumped 71 per cent. Since then prices have steadily risen from \$6.50 per barrel to \$13.75. Since December 1978 alone, the imported price of crude oil to Canada has jumped again by more than 50 per cent to over \$25 per barrel. The current gap between Canadian oil prices and the average U.S. price at Chicago exceeds \$5 per barrel. By most reasonable forecasts it could be roughly a \$7 gap next year. President Carter has indicated that the United States will be at world prices for oil by 1981.

The prospect of continued increases in international oil prices putting further pressure on domestic prices is virtually assured. Even with Canadian prices below the Chicago price, the nation may be facing very large new oil and gas revenue flows coming out of the pockets of domestic consumers and into the hands of the producing provinces, the petroleum corporations, and the federal government.

At the recent Tokyo Conference of the major industrial countries, the federal government committed Canada to move as fast as possible to world crude oil prices. The "world price", however, is not a sensible price Canadians must pay. Our unique energy flexibility within the industrial community should allow us to choose our own course. Nonetheless, Ontario cannot ignore the array of factors pressing for upward price movements if it is to play an effective intergovernmental role in maximizing the present and long-term interests of Ontario.

The Position of the Government of Ontario:

1) Immediate Pricing Policy:

Ontario recognizes external pressures for crude oil price increases; moreover, Ontario is determined to play an active, positive role in national energy policy. Nevertheless, bearing in mind Canada's continuing capacity to choose its own policy, the present dangers already before our economy and the impacts of price increases under present pricing arrangements, Ontario is opposed to any immediate price increase beyond the current January 1980 agreement which calls for a \$1 per barrel increase.

2) Comprehensive Adjustment Policy:

If Canadian oil prices are allowed to rise substantially at any time, there must be a basic change in revenue flows and energy and economic policies to:

- . achieve national oil self-sufficiency;*
- . avert an unnecessary recession;*
- . avert undue hardship on the consumer; and*
- . enhance industrial adjustment.*

Impacts of Rising Prices Without New Leadership

At present, the oil pricing arrangement between the federal government and the producing provinces calls for a \$1 per barrel increase on January 1, 1980. There is a possibility that this will not be the only increase implemented over the next 12 months. A significant deficit for the federal government on its oil compensation program and commitments made at the recent Tokyo summit indicate that the federal government is actively considering an increase that could be substantially higher than the current agreement.

Without new reinvestment policies, such as those presented later in this paper, higher Canadian oil and gas prices will result in a substantial decline in real spending power across the country. Real economic growth in Canada could be reduced by 0.3 to 1.4 percentage points depending on an estimated oil price increase of from \$2 to \$7 per barrel. This lost output will be occurring at the same time that the U.S. economy, Canada's principal export market, is heading into a recessionary phase exaggerated by recent international oil price increases. Moreover, the regional effects in Canada are by no means balanced. The economies of oil and gas producing regions will continue to grow while those of consuming provinces could slow significantly.

Table 1 illustrates the impacts on Ontario's real income growth and inflation associated with an annual increase in its total oil and gas bill of \$620 million, \$1.55 billion and \$2.17 billion respectively. These flows represent the additional cost to Ontario in the event of a \$2, \$5 or \$7 per barrel oil price increase. The monies flow out of the Ontario economy and represent a net burden on Ontario consumers and a reduction of their real spending power. Table 2 illustrates the typical direct effect on the average household's heating and automobile operating costs. This burden is particularly heavy for those with low incomes and those living in rural areas who do not have an immediate option to

change their mode of transport. The net effect would be to reduce employment growth in the province. This would substantially erode the significant and successful efforts that have been undertaken recently to expand employment growth in Ontario.

ECONOMIC IMPACTS OF POSSIBLE
OIL/GAS PRICE INCREASES IN 1980

Table 1

	Average Oil Price Increase*		
	\$2	\$5	\$7
	(percentage points)		
Inflation - Consumer Price Index	+0.8	+2.2	+3.2
Ontario Real GPP - Growth	-0.4	-1.0	-1.5

* Average domestic price increase in 1980 over 1979 level with natural gas indexed at 85 per cent.

INCREASED ANNUAL COST TO TYPICAL HOUSEHOLD
DUE TO POSSIBLE OIL/GAS PRICE INCREASES IN 1980

Table 2

	Average Oil Price Increase		
	\$2	\$5	\$7
Home Heating	\$48	\$120	\$168
Automobile	\$40	\$100	\$140
Total	\$88	\$220	\$308

Note: Household uses 800 gallons of fuel oil for space heating and travels 12,000 miles per annum at an average fuel efficiency of 18 miles per gallon. Assumes natural gas indexing at 85 per cent.

Inflation rates have been rising for the past two years with wage gains falling behind. An increase in oil prices of \$5 per barrel with natural gas indexed to oil would add 2.2 percentage points to a rate of inflation already fueled by

These monies are in addition to the cumulative \$22 billion of new revenues that have been generated by price increases since 1973. The eventual size of fiscal imbalances created by revenue flows of these orders of magnitude is staggering and represents a significant challenge to the flexibility of the central financial arrangements of Confederation.

higher food and import prices. Such sharp increases in Canadian energy prices would exacerbate the problem with the potential for fueling a wage spiral that would undermine competitiveness.

The decline in real purchasing power that results from oil price increases can only be offset through increased productivity and not through gaining higher nominal incomes. Ontario, for example, as an importer of oil must increase its exports or reduce its imports of other goods in order to pay for higher priced oil. This means becoming more competitive. Unless an effective mechanism is found to respond to substantial shifts in regional income distribution, without generating widespread demands for compensating increases in all incomes, then both more inflation and higher unemployment will result.

Domestic oil and natural gas price increases have dramatic potential for generating new revenue flows in Canada. Table 3 illustrates the distribution of the new annual revenue flow amongst the federal government, the producing provinces and the petroleum industry under existing tax and royalty arrangements. It is important to note that, whether price increases occur all at once or over regular intervals, essentially the same total volume of funds will eventually flow annually to the various recipients.

DISTRIBUTION OF NEW OIL/GAS REVENUES, 1980		Table 3		
	Average Oil Price Increase ¹			
	\$2	\$5	\$7	
	(\$ billion)			
Total New Revenues From Canadian Production	1.96	4.77	6.55	
- Federal Government	.24	.74	1.34	
- Producing Provinces	.88	2.20	3.08	
- Petroleum Industry ²	.84	1.83	2.13	

1. 1980 domestic price increase per barrel over 1979 level. Assumes natural gas indexed at 85 per cent and existing tax/royalty regimes.
2. Assumes that industry reinvests about 80 per cent of its share of the \$2 price increase in exploration and that the reinvestment proportion per barrel declines as the price rises beyond that.

II. A REINVESTMENT PLAN FOR CANADA

The potential magnitude of the eventual flows of oil and natural gas revenue is such that unless this issue is addressed the country will be severely strained in both economic and social terms*. In 1978, net operating income of the petroleum sector in Canada was \$9.6 billion. That is more than 7 times the amount in 1970. Even if domestic oil and natural gas prices continue to rise at existing rates (\$1 every six months), by 1985 the revenue flows could be close to three times as much as the 1978 figure. That Canada needs an effective reinvestment policy to deal with growing financial imbalances resulting from oil and natural gas price increases has been illustrated by the following:

- . Fiscal imbalances have grown dramatically over the period since 1973. The Alberta Heritage Fund, for example, has accumulated almost 5 billion dollars, mostly in short-term financial assets. Even without further price increases this financial pool will grow at over a billion dollars per year. Ontario consumers contribute approximately 29 per cent of the Fund.
- . The oil and natural gas fiscal imbalances have put severe strains on Confederation and the federal government's financial capacity to guarantee fiscal equalization. This has already led to new and artificial measures designed to limit the equalization payments to recipient provinces.
- . The real growth rates of the energy producing provinces have vastly exceeded those in the rest of Canada and have resulted in increased regional development disparities. A renewed round of rapidly rising oil and natural gas price increases will widen even further the long-run regional economic growth imbalances.
- . The fiscal capacity to fund major economic stabilization measures is extremely limited at the federal level. It is also limited at the provincial level outside energy producing provinces because of the revenue and cost effects on their budgets of higher domestic oil prices.

* See Appendix B, Economic Policy Lessons From the Seventies.

A National Energy and Employment Adjustment Program

A National Energy and Employment Adjustment Program could be established with joint federal-provincial co-operation. The objectives of the Program would be to:

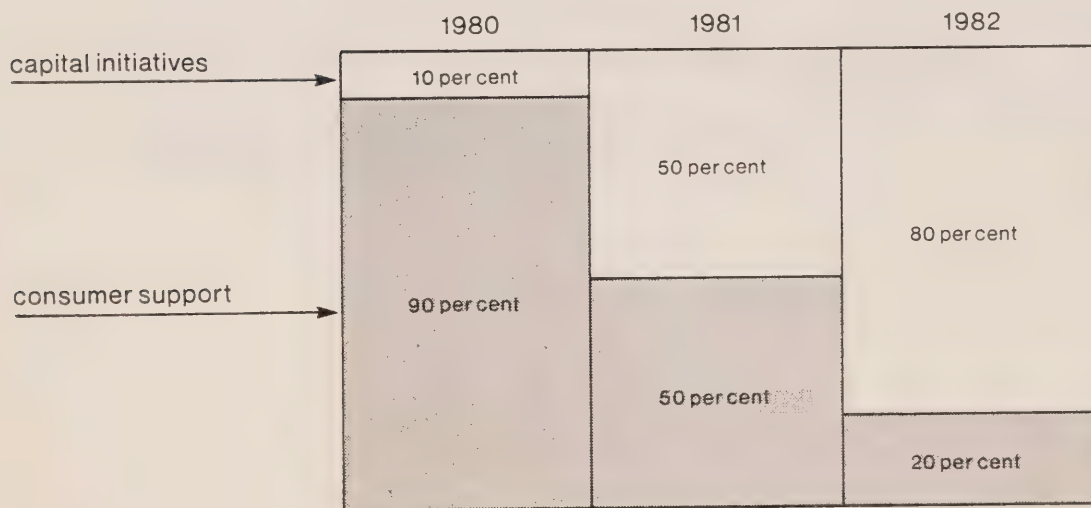
- 1) *achieve crude oil self-sufficiency through increased conservation, interfuel substitution and increased domestic supply;*
- 2) *sustain economic growth at low levels of inflation; and*
- 3) *support a new industrial strategy.*

The funds available to pursue these goals may be massive. Certain key principles should be adopted:

- . The oil industry need not receive additional revenues that cannot be effectively and sensibly re-invested in petroleum exploration and development. Increased oil and gas supply is only one element in a balanced pursuit of national energy security.
- . The federal government receives significant new revenues when oil prices rise. Except for funds required to contain the cost of a one price oil policy for all Canadians, all new revenues must be set aside to help achieve energy security and to avert an unnecessary and wasteful recession.
- . The adjustment to higher oil prices for Canada should not be financed in New York; Canada needs the co-operation of the Governments of Alberta and Saskatchewan, whose treasuries receive the lion's share of petroleum sector revenues. In light of the assured and potentially massive increases to these provinces, the federal government must secure a significant contribution to this program from producing provinces as part of any negotiations which envisage substantial oil price increases.

Leadership by the federal government will be absolutely essential, if these funds are to be mobilized effectively. Accordingly, the management of this program should be primarily its responsibility. However, participation by the provinces will be crucial, particularly regarding capital projects which relate directly to existing provincial responsibilities.

The cost of crude oil self-sufficiency will be high but an economic recession is a price that can and should be avoided. Major energy related capital projects would aid in economic stabilization, but it is unlikely that a program of sufficient size could be planned and implemented in order to sustain demand in 1980. Moreover, a sharp drop in consumer demand would add to excess capacity and reduce investment demand in non-energy sectors of the economy. A depressed economy would only make necessary changes more difficult and more divisive. Accordingly, most of the funds immediately available from higher prices should be returned to the consumer, while capital support initiatives are designed and put in place. Graphically, this pool of money might be apportioned, for instance, in this way:



Specific Actions:

1) Pursuing Oil Security:*

In the early 1970's Canada was oil self-sufficient, but at present close to 20 per cent of net oil requirements come from abroad and by 1985 over one-third of the nation's needs might have to be met by imports. A program of accelerated development of oil sands and heavy oil projects would make a substantial contribution to increasing domestic oil supply. Moreover, a regionally balanced return to crude oil self-sufficiency must also include accelerated oil conservation and substitution initiatives. For instance, the following proposals should be developed as part of the reinvestment plan:

- . *Enriched home energy conservation grants to reduce oil bills through: adding insulation, re-designing buildings, furnace efficiency improvement, and the replacement of oil furnaces by alternative fuel heating systems, particularly natural gas.*
- . *A tax credit for public transit riders.*
- . *Additional funds to expand and up-grade public transit systems.*
- . *Increased fiscal incentives for heat recovery and energy efficient equipment for business and industry.*

* See Appendix C for a further discussion of this objective.

2) Sustaining Economic Growth*

Higher oil and natural gas prices result in a reduction of the real purchasing power of consumers. To sustain employment, an effective reinvestment policy would have to focus on restoring general consumption as well as investment spending. Moreover, as oil substitutes are not always immediately or wholly available, consumer support policy must also attempt to alleviate some of the inequities of higher oil prices. New policy measures also should be designed to reduce the direct and indirect inflationary impact of energy price increases. Therefore, along with any further oil price increase, the federal government must consider:

- . *A temporary tax credit or grant to help low income consumers absorb the unavoidable loss of income, particularly due to increased costs for home heating oil.*
- . *A temporary cut in indirect taxes (e.g. retail sales or manufacturing sales taxes) to sustain consumption and reduce inflation.*
- . *Even with the consumer cushion available from the above measures, the C.P.I. could escalate sharply. In order to help avert a further escalation of inflationary expectations, preparation of a new national anti-inflation strategy is appropriate.*

* See Appendix B for a further discussion of this objective.

3) Accelerating Industrial Adjustment*

Canada's industrial strategy must become more energy sensitive. Increasing the efficiency of energy use and the productivity of both labour and capital is essential to offset the long-run reduction in real income resulting from higher oil and gas prices. Furthermore, a new energy conscious Canadian and world environment will produce new supplies, materials and equipment that use energy more efficiently. The business sector has a major role to play not only as a consumer of oil products, but as a key catalyst in terms of the development of new sources of energy and energy efficient products. Therefore, the reinvestment program must assist this positive adjustment. The following proposals should be considered:

- . *A massive program to develop new energy efficient products and technology in the Canadian automobile parts industry, using additional incentives to industrial research and development.*
- . *Tax incentives to assist business and industry to improve energy efficiency and to expand gas distribution networks to encourage the conversion from oil to natural gas.*
- . *Support for developmental costs, for small as well as large enterprises, in the areas of:*
 - *renewable energy*
 - *public transit*
 - *instrumentation*
 - *district heating*
 - *rail electrification*
 - *energy from waste.*

* See Appendix D for a further discussion of this objective.

III. FINANCING A BALANCED CANADIAN ECONOMY

Funding the National Energy and Employment Adjustment Program

Contributions to the funding of the National Energy and Employment Adjustment Program must come principally from the new petroleum revenues that would accrue to the federal government, the petroleum corporations and the producing provinces in the event of substantial price increases. Table 4 illustrates the funds that would be available, and would be necessary, if oil prices were allowed to rise substantially in 1980.

CONTRIBUTIONS TO NATIONAL ENERGY, AND EMPLOYMENT ADJUSTMENT FUND ¹		Table 4
		Year 1
		(\$ billions)
Federal Government		0.50
Petroleum Corporations		0.99
Producing Provinces		1.32
Total		2.81
1. In the event of a \$5 increase in oil prices (with natural gas indexed at 85 per cent) in 1980.		

(i) The Federal Government

As Table 5 indicates, even under its present tax structure, the federal government would enjoy a significant increase in budgetary flexibility if it allowed domestic oil prices to increase by substantially more than \$2. If that is its decision, these additional monies should be set aside for reinvestment in the National Energy and Employment Adjustment Program and not absorbed for general government purposes. This allocation would still allow substantial monies to the federal government to meet increased equalization and transfer payment obligations.

SOME CHANGES IN THE FEDERAL GOVERNMENT'S
FISCAL POSITION
(\$ Million)

Table 5

Base domestic oil price \$13.75	Average Oil Price Increase ¹		
	\$2	\$5	\$7
A. GENERAL REVENUES			
. Increased Corporate Income Tax on Oil/Gas Sector	+240	+740	+1,340
. Increased Indirect Taxes	+20	+40	+60
. Total	+260	+780	+1,400
B. OIL COMPENSATION PROGRAM			
. Reduced Oil Export Tax	-140	-350	-490
. Savings on Oil Compensation Payments ²	+340	+850	+1,190
. Balance on the Program ³	-300	0	+200

1. 1980 domestic price increase over 1979 level. Assumes natural gas indexing at 85 per cent and existing tax/royalty regimes.

2. Further reduction in these payments (associated with reduced oil imports and slower oil consumption growth) is possible. It also assumes no further world oil price increase.

3. These numbers indicate the net cost of the program to the federal treasury to be financed out of the Consolidated Revenue Fund. This assumes a \$500 million deficit in the program in 1980, given no increase in domestic oil and gas prices.

(ii) Petroleum Corporations

The petroleum industry in Canada, on average, is now effectively reinvesting a large proportion of its share of petroleum production income, that is from 80 to 85 per cent. Moreover, their reinvestment will continue to play a key role in achieving adequate domestic oil and natural gas supplies for the future.

Nevertheless, past events indicate that sharp domestic price increases result in increased revenues which cannot be immediately and efficiently employed in oil and gas production and exploration. If oil prices were to rise by more than \$2, petroleum corporations would receive more additional revenues under present tax arrangements than they could quickly and efficiently reinvest in additional crude oil supply. These additional funds could be captured by the federal government through a number of taxing options.

It should be pointed out that, in this example, the oil industry would still be retaining over \$800 million of new revenues flowing from a \$2 price rise. These monies can and must be committed to help achieve increased domestic supplies. However, to go beyond this amount would reduce the nation's capacity to finance those economic and energy objectives beyond the competence of the petroleum sector.

(iii) The Producing Provinces

Were Canada a unitary state the energy "crisis" to Canadians would be much less of a crisis. The uneven distribution of petroleum resources and provincial control over resources are at the heart of the issue: a contribution from the 46 per cent of new oil and gas revenues flowing to producing provinces to pursue national economic and self-sufficiency objectives beyond their own borders is critical.

The approximate \$1.5 billion of new oil and gas revenues available from the federal government and the petroleum corporations would make, for example, a substantial contribution to achieving the short-term economic objectives of the reinvestment plan. However, the fully balanced program of adjustment outlined above cannot be undertaken successfully without a

comparable contribution from the producing provinces of Alberta and Saskatchewan. The Government of Canada should negotiate the contribution of the revenues accruing to producing provinces over and above a \$2 price increase.

This would not deny the proprietary claim to an additional return on an asset owned by the producing provinces. Indeed, such an arrangement would still provide new additional provincial revenues of \$880 million annually. Recognizing the fiscal limits on the federal government, the contribution of the producing provinces should not carry some specific future obligation to repay on behalf of the citizens of Canada. Their contribution would again confirm the general and historic obligation of all members of Confederation to aid the country in a potential national crisis.

In the first instance, the federal government should pursue such an arrangement by negotiation among Canadians. However, it should be well understood by the federal government that it is charged with the responsibility and has the legitimate constitutional authority to avert an intolerable economic and social danger. If necessary, the federal government must use its influence and constitutional authority to direct oil and natural gas revenue flows in accordance with agreed national objectives. Any decision to increase oil prices substantially must provide for a significant restructuring of present revenue flows.

(iv) A Fund and the Role of the Public Sector

In order to maintain the integrity of the contributions to the reinvestment program as outlined, it might be desirable to establish a specific "Fund" rather than put these potential monies into the federal consolidated revenue fund. This is not to suggest the creation of a new bureaucracy or massive direct intervention by government into petroleum production. Indeed, it would be unnecessary and unwise for government to duplicate the supply

activities now adequately carried out by the private sector. Moreover, the conservation and fuel substitution initiatives envisaged under the reinvestment program will and should work primarily through the private marketplace. The public sector, however, does have ongoing responsibility to participate in high-risk frontier development, as presently carried out by PetroCanada Limited. These responsibilities must be maintained.

The duration of the Fund and its activities are an open-ended option depending on international energy events. The capital projects it could finance would naturally continue over some time. As an illustration of how the Fund might accumulate (assuming contributions are made on the same percentage basis as illustrated for year one in Table 4) after three years, the Fund would have received a total of \$7.8 billion to meet its objectives.

All provinces have a stake in Canadian crude oil self-sufficiency by 1995. Consuming provinces have particular responsibilities with regard to conservation measures, public transit, and the accelerated development of alternative energy resources.

The Ontario Government will be undertaking new initiatives in all these areas. Specifically, some of the monies currently going into general industrial adjustment programs will be re-directed to assist in energy conservation. For example, Ontario's Employment Development Fund will strengthen its focus on energy conservation initiatives in industry.

It is vital to understand, however, that in the event of substantial oil price increases, provincial finances will be further constrained, unless a National Energy and Employment Adjustment Program is put in place. The consuming provinces alone cannot compensate for such an outflow of purchasing power through massive borrowing. However, they can and should help meet the goals of the programs outlined in this paper, if the reinvestment plan is put in place.

The Long Term Fiscal Challenge

The funding arrangements outlined above are focussed on meeting urgent economic and energy objectives should the federal government raise oil and natural gas prices substantially at this time. The reinvestment plan has limited and feasible objectives, but it is not designed to address fully the long term challenge. The underlying fiscal shifts will require ongoing negotiations and debate at the highest level. The global shift to more expensive energy is fundamentally changing the balance of Confederation in ways that are only just beginning to be understood.

The major new perception of the domestic oil and natural gas pricing issue in Canada must surely be that it is a crisis not only of oil availability or short-run economic adjustment, but also one of profound regional economic and fiscal imbalance over the long-term. This is particularly evident in the growing fiscal imbalances. By March 31, 1979 Alberta had \$4.7 billion and Saskatchewan \$0.48 billion in their respective Heritage Funds. Even with no further oil and natural gas price increases, the Alberta Fund could grow by over \$1 billion a year. Should domestic oil prices be allowed to reach the world level in the next year, the size of the Alberta Fund could grow to a staggering \$24 to \$25 billion in 1985. This compares to a projected \$27.5 billion in the entire Canada Pension Plan fund in the same year.

Over the next few years, the First Ministers will need to address the question of permanent regional fiscal imbalance that present tax and equalization arrangements entail. Just as our public leaders addressed contemporary social realities in the 1930's and 1940's, a fundamental review of Canada's capacity to live equitably together in an era of expensive energy must now be undertaken.

To this end, Ontario recommends that the Ministers of Finance and Treasurers of Canada begin work now to study together the impact of resource revenues on the future of Confederation. They should report and make recommendations to the First Ministers by the Fall of 1980 on long-term ways to reinvest equitably and more effectively federal and provincial resource revenues.

APPENDICES

- A. BLENDED PRICE PROPOSAL
- B. ECONOMIC POLICY LESSONS FROM THE SEVENTIES
- C. CRUDE OIL SELF-SUFFICIENCY: CONSERVATION AND SUPPLY
- D. INDUSTRY ADJUSTMENT STRATEGY

APPENDIX A: BLENDED PRICE PROPOSAL

Ontario has proposed a blended price mechanism which would automatically relate the price Canadian refineries pay for the crude oil they refine to the prices paid for domestically produced and imported crude oil. In essence the blended price would be a weighted average of the prices for "old" (already developed) oil, "new" (recent domestic additions) and imported oil. The price for "old" oil - crude oil already discovered and in production at costs significantly lower than prevail today would be fixed at today's level. The "old" oil price would be subject to review and negotiation should cost circumstances change. The price for "new" oil would be at a different, and presumably higher, level in recognition of the higher costs of much new oil production from deeper zones in established oil producing areas, from secondary and tertiary enhanced recovery schemes, from frontier region resource areas and from oil sands developments. The price of imported oil lies outside the control of Canadians.

The blended price option has several merits. It could

- . slow the rate of price increase;
- . reduce the need for short term economic stabilization programs;
- . slow the growth in fiscal imbalances among provinces;
- . eliminate the need for the federal government's oil compensation program as currently operated and thus remove an important connection between domestic crude oil prices and the federal government's overall budgetary position;
- . remove the need for a specific levy on Syncrude;
- . directly relate the price incentive to new oil production (the incentives of knowing that a higher price would be available for "new" oil would have a marked impact on development); and
- . provide an automatic adjustment to changing world oil prices.

A number of disadvantages to the blended price options have also been identified. These are:

- . producers and governments of producing provinces have resisted adopting such a mechanism which they regard as a direct subsidy to users of energy;
- . the petroleum industry has traditionally funded most of its investment in new supplies from cash flow. By restricting the price level afforded to the production of "old" oil, the cash flow available for reinvestment would be reduced (this negative effect is to some extent offset by the fact that over half of the revenues from a price increase flow to governments); and
- . the need for increased bureaucracy to administer the blended price mechanism. (To a certain extent current mechanisms such as the federal oil compensation program and the Syncrude levy already reflect the blended price option and part of the bureaucracy is therefore in place).

An essential point with regard to adopting the blended price option is that as the quantity of "old" oil declines the Canadian oil price moves closer to the cost of new supplies.

APPENDIX B: ECONOMIC POLICY LESSONS FROM THE SEVENTIES

The first oil price shock followed quickly in the wake of the Arab oil embargo and OPEC price increases of 1973. The domestic price of oil went from \$3.80 per barrel in 1973 to \$8.00 per barrel in 1975. Because Canada possessed considerable domestic supplies of oil and natural gas, it was possible to keep domestic price increases below international price increases. There was, nonetheless, a massive transfer of income from domestic oil and natural gas consumers to domestic oil and natural gas producers. This also meant that there was a redistribution of income from oil and gas consuming provinces to net producing provinces within Canada. The result was a substantial increase in both domestic inflation and unemployment and a significant slowing in the growth rates of oil consuming provinces compared to oil producing provinces. Moreover, accompanying these transfers and their effects was an enormous redistribution of fiscal capacity amongst governments without an improvement in longer term oil security. This experience has taught Canadians a number of important policy lessons. Specifically, it has demonstrated the need for:

- . an effective and comprehensive strategy to achieve crude oil self-sufficiency;
- . an effective and timely employment and anti-inflation strategy;
- . a coherent policy of adjustment assistance to key Canadian industries both to adapt to oil cost increases as well as to take advantage of new energy-related opportunities; and
- . an effective petrodollar reinvestment policy to deal with growing and potentially staggering fiscal imbalances resulting from oil and gas price increases.

The Canadian experience to date, therefore, has demonstrated the need for effective national and provincial policies to deal with the questions of oil self-sufficiency, inflation, employment, long-run industrial adjustment and fiscal imbalance. It has shown Canadians, and particularly those in consuming

provinces, how vulnerable they are to the international economics and politics of oil. Indeed, the current round of OPEC price increases and the political turmoil in Iran have highlighted that vulnerability. But what these events have also clearly demonstrated is that domestic energy policy cannot be separated from its enormous economic, industrial and fiscal implications. Oil self-sufficiency is as much an economic and fiscal problem as it is a question of resource availability. Accordingly, the policy response must be on all of these fronts and it must be an integrated strategy.

For example, conservation efforts focused on achieving oil self-sufficiency can simultaneously help to diminish the rate of inflation, increase employment and create a strategic new industrial opportunity for the manufacturing sector. Reduced household and business oil demand will help to contain rising costs and prices. Increased energy-saving renovations will add demand and jobs in the underutilized construction sector. In fact, over the longer term declining household formation indicates that this activity may be a main growth generator in the residential construction sector. At the same time, innovative conservation materials and technology can be produced in the manufacturing sector, not only for domestic use but also for an energy conscious export market.

The timing of various policy initiatives can be set to achieve the maximum results in terms of Canada's economic and self-sufficiency objectives. The important point is to ensure that the monies flowing out of consumers and industry from increased domestic oil prices are being re-spent as quickly and productively as possible to sustain consumption and investment demand and achieve the goals of industrial adjustment and oil self-sufficiency.

That the country needs an effective employment and anti-inflation policy to deal with the large oil and natural gas price increases is evidenced by the economic impact of the 1973-74 domestic and international price increases.

- . The energy component of CPI rose 9.0, 15.3, 13.5 and 15.4 per cent in the years from 1973 to 1976 inclusive, despite the fact that Canada's energy prices did not rise as fast as world energy prices.
- . The Ontario unemployment rate rose from 4.3 per cent in 1973 to 6.3 per cent in 1975 and has remained over 6.0 per cent since that time. Over one-quarter of the additional unemployment resulted from oil and natural gas price increases.
- . The general rate of inflation rose from 4.8 per cent in 1972 to over 10 per cent in 1974 and 1975.
- . The impact of energy prices was a major factor in Ontario's \$600 million fiscal stabilization initiative in 1975 to maintain job creation but which had to be financed by resort to foreign borrowing.

By the same token, the experience of 1973-75 taught certain important lessons in how to adjust to higher oil and gas prices. The absence of monetary restraint and the absence of public sector expenditure restraint augmented significantly the domestic inflationary pressures that resulted from oil and gas price increases. In 1973, Canadian costs were already rising more rapidly than those in the United States. Higher domestic oil and gas prices simply escalated income demands even further and compounded the problems of international cost competitiveness. An effective anti-inflation environment is absolutely essential to minimize the economic dislocation resulting from oil price increases.

The loss of international cost competitiveness also made attempts to stabilize domestic demand much less effective since import demands were increased. Moreover, higher inflation and uncertainty over the energy outlook raised domestic savings rates, again reducing demand.

All governments suffered the cost escalation associated with energy price inflation. At the same time the personal income tax revenues, because of inflation indexing and an oil induced economic slowdown, were not rising as rapidly as costs. Particularly in oil consuming provinces the squeeze of higher cost and lower revenue growth was dramatic. Attempts to offset the economic recession and the high costs of unemployment therefore had to be financed by foreign borrowing. Foreign borrowing, however, helped to maintain an artificially high value for the Canadian dollar in 1975 and made Canada's international competitive position even less viable. The net result was a reduction of the effectiveness of the efforts to stabilize the domestic economy.

The problem was not in the decision to sustain domestic demand. The problem lay in the method of financing this demand. Heavy reliance was placed on monetary expansion and foreign borrowing which combined to produce an overvalued currency and loss of competitiveness. Improved results could have been obtained from a deliberate attempt to mobilize domestic petrodollars in support of domestic spending.

The fiscal capacity to finance demand support without resort to foreign borrowing did exist in Canada. The complication was that it was maldistributed through the flow of new oil and gas revenues. The consuming provinces needed the demand support but the producing provinces and petroleum corporations were collecting the revenues necessary to finance it. The federal government and the consuming provinces did not have, and do not now have, the fiscal capacity to make up for this loss in purchasing power, without running chronically high and undesirable deficits.

The lessons of inflation and employment policy that we have learned are simply stated:

- there must be an effective anti-inflation strategy;
- employment strategies must somehow be financed out of the new domestic revenue flows generated by oil and gas price increases; and
- government expenditure restraint and a stable monetary growth are essential in order to create permanent jobs in the private sector.

APPENDIX C: CRUDE OIL SELF SUFFICIENCY: CONSERVATION AND SUPPLY

That Canada needs an effective crude oil self sufficiency strategy is indicated by the fact that despite rapid oil and gas price escalation since 1973-74:

- . There is a sharply rising dependence on foreign oil. In 1972-74 Canada was oil self-sufficient but at present close to 20 per cent of requirements come from abroad and by 1985 over one-third of our needs might have to be met by imports.
- . Natural gas reserves have increased significantly but there has been little headway in substituting surplus natural gas for oil.
- . There have been some energy conservation initiatives introduced (for example, the federal home insulation program) but there has been no comprehensive national assault on oil conservation measures. Demand for oil continues to grow at 2.4 per cent per annum.
- . There has been no major speed up of tar sands development despite the tripling of oil prices in 1973.

A national commitment on the part of all governments is urgently required. There are three basic elements for achieving self-sufficiency in crude oil:

- . reducing consumption through conservation;
- . reducing oil requirements by substitution of other fuels, for example natural gas, electricity, coal and renewables; and
- . increasing supply, mainly through oil sands and heavy oil production.

Conservation

An effective oil conservation strategy must be directed at the transportation sector for the following reasons:

- . About 45 per cent of petroleum consumption occurs in the transportation sector with the major portion for the private automobile;

- . There is relatively little room for interfuel substitution in the transportation sector;
- . The private car is the dominant and much-preferred mode for personal transportation;
- . The current energy problems in the United States have hit hardest in the transportation sector (for example in lineups at gasoline stations and a nation-wide trucking strike over diesel fuel allocations);
- . The downsizing of motor vehicles represents one major area of success in U.S. policy. The effect of the vehicle downsizing presently contemplated will reduce Canadian consumption of petroleum in 1985 by the equivalent of one oil sands plant; and
- . There continues to be a great deal of potential for successful conservation initiatives in the transportation sector (e.g., in the shift to public transit, a shift to rail from automobile and air in intercity transportation, improved vehicle maintenance, and the transition to newer and hence more fuel-efficient vehicles).

Rapid downsizing of automobiles and higher efficiency in their fuel consumption is absolutely essential. As well, the possibilities for a renewed emphasis on urban transport are clearly evident. There is, moreover, a major role for local governments in the design and implementation of transit programs because local systems will require unique programs and because a variety of actions at the local level will be crucial to the success of new and aggressive transit initiatives.

Another priority for conservation policy is the use of oil in home heating where reductions can be achieved through adding insulation, redesigning buildings (retrofitting), furnace efficiency improvement and the replacement of oil furnaces by alternative fuel heating systems. This offers substantial immediate and continuing opportunities to reduce the inflationary effects of higher oil prices on household budgets while simultaneously increasing economic activity and employment in the construction industry. Conservation savings in the industrial sector in respect to heating can also be achieved. Canada has a very

high proportion of its capital stock in the form of plant and buildings compared to the United States. Hence the relative savings in oil and in operating costs could be substantial in the business sector.

By 1985, oil conservation programs could achieve a saving of 250,000 barrels of oil per day and by 1990 something in the order of 370,000 barrels per day. That is roughly the equivalent of 2 and 3 oil sands plants, respectively.

Substitution

Canada currently enjoys a surplus of natural gas. There is considerable potential for natural gas to replace oil. The National Energy Board estimated some 100 thousand barrels/day of oil could be displaced by a 25 per cent penetration of natural gas in Eastern Canada. In Ontario, natural gas could capture a large part of the current share of the residential and commercial sectors' oil consumption. Incentive pricing schemes, expanded gas distribution systems and financial aid for equipment changeover could be instrumental in realizing the potential oil displacement and in creating jobs. Similarly, the relative price of United States' coal makes it an attractive option for industry. On the other hand, attractiveness of Canadian coal is limited by the high costs of transportation and suggests that ways might be explored to lower these costs through more efficient transportation systems.

The current structure of relative prices limits the degree to which electricity can substitute for oil, except possibly in Quebec. In the long term, however, electricity and renewable sources could play a larger role.

New Supply

Although the high level of exploration and development has led to some discoveries of new crude oil, the volumes do not offset the deterioration in Canada's oil supply position. The prime source of major additions to supply is generally accepted to be the oil sands and heavy oil projects. Since the approval of Syncrude in 1973, no further plants have been committed for construction. Two plants, the Alsands (Syncrude type) and Imperial Oil Cold Lake (in situs) facilities, are about to proceed. A prime concern of Ontario is to obtain a further commitment to a program of accelerated construction of other similar plants, or their equivalent, to help achieve crude oil self-sufficiency.

There are, however, a number of major constraints and legitimate concerns related to too rapid a development of oil sands and heavy oils:

- . possible resistance by the government of Alberta on environmental and social grounds;
- . the likelihood of generating severe cost pressures in Alberta or strains on Canadian capital markets;
- . the inadequate availability of skilled labour;
- . the need to make major improvements in essential technology; and
- . the possibility of accentuated regional economic imbalances through the flow of labour and capital to Western Canada with a correspondingly reduced potential for economic development in Central and Eastern Canada.

Conclusion

Canadian oil self-sufficiency will require action on all three fronts - conservation, substitution and developing new supplies. The National Energy Board analysis, which included a large measure of conservation, indicates 7 oil sands or heavy oil plants are required by 1995 to achieve self-sufficiency. In light of the constraints and concerns expressed above, an oil sands development program of about 4 to 5 additional plants together with accelerated conservation and substitution initiatives may be more appropriate and feasible. These latter initiatives also have a greater potential for creating economic activity in Eastern Canada. For consuming provinces, their long run "balance of payments" and growth prospects are best served through conservation efforts and encouraging domestic energy supply with substitution for oil. This would also best serve the national objective of balanced regional growth.

A simple estimate of the additional costs to achieve crude oil self-sufficiency is \$35 billion which represents 7 oil sands plants or their equivalent in conservation and substitution initiatives. Recognizing the high costs of attaining crude oil self-sufficiency, it is discouraging to see that, of the \$22 billion of incremental revenues generated by the past price increases, less than one-third has gone to increasing supplies through exploration and development and synthetic oil investments. Half of the revenues have flowed to the producing provinces in the form of royalties and land bonuses. What is urgently required is a commitment by all governments to a national plan to achieve crude oil self-sufficiency and to the development of funding mechanisms to make it possible.

APPENDIX D: INDUSTRY ADJUSTMENT STRATEGY

That this country needs a coherent policy directed to help key Canadian industries both to adapt to the increased cost pressures that will result from increased oil prices and to take advantage of new energy related opportunities is reflected in the following considerations:

- . Higher energy prices have left Canada with a substantial part of its capital stock energy inefficient.
- . Canada's industrial mix is very energy intensive by international standards.
- . Canadian industry is relatively energy inefficient compared with its major competitors.
- . Comparatively little R & D is being done by industry with regard to renewable energy technologies.
- . A significant proportion of the expenditure in oil and natural gas developments finds its way into imported goods and services thereby constraining the potential to develop a competitive Canadian capability.
- . An energy conscious world means that our industries must compete in the international and domestic markets with energy efficient equipment and appliances.

Increasing international energy prices have led to the introduction of energy efficient techniques and products by Canada's major trading partners. If Canada's manufacturing sector is to remain competitive in an increasingly energy conscious world, its industrial strategy must become more energy sensitive. The potential for increased energy efficiency is substantial, but can only be realized by investing in new energy efficient capital equipment, and by increasing substantially research and development designed to increase the energy efficiency of Canada's manufactured products and processes.

Increasing the efficiency of energy use and the productivity of both labour and capital is essential to offset the real income reduction resulting from higher oil and gas prices. The business sector has a major role to play not only as

a consumer of oil products, but as a key catalyst in terms of the development of new alternative sources of energy and new energy-efficient products.

For most of Canada's manufacturing industries, including the five heaviest energy users, capital investment could lead to substantial energy savings. New plant and equipment are generally more energy efficient than old ones. Therefore, factors that act to increase capital formation will improve energy efficiency. It has been estimated that the level of new capital investment which would be undertaken to improve energy efficiency in manufacturing would range from \$926 million at a \$2 price increase to over \$3 billion at \$7 price increase, if effective adjustment support measures are in place.

Industries with a high total energy consumption, where the potential for improved energy efficiency would be greatest, include primary metals, non-metallic mineral products, paper and allied products and food and beverage. Industries which could benefit most from more energy efficient products include the automotive industry, major electrical appliances, and a wide range of motor driven machinery and equipment. In addition, special assistance from the reinvestment plan may need to be considered for certain firms heavily reliant on crude oil.

It is desirable that programs and incentives be introduced to help industry to adapt to higher energy prices especially higher oil prices, and also to adjust to the potential of reduced long-term oil availability. This will necessarily involve measures to promote energy conservation and interfuel substitution.

- . Conversion costs incurred by industrial users from oil to natural gas or other energy sources could be subsidized. Similarly, efforts to make it commercially viable for refiners to upgrade residual fuel oil would be desirable.

A new energy conscious Canadian and world environment will produce new supplies, materials and equipment that use energy more efficiently. Therefore, policies must be in place to encourage the development of Canadian business capability to ensure that it capitalizes on these new opportunities.

The strategic importance of the automobile industry in Ontario suggests a massive program to develop new energy efficient technology in the automobile parts industry which would serve the interests of both oil self-sufficiency and long-run economic development. It would also be consistent with Ontario's desire to reduce an estimated \$4 billion auto parts deficit and achieve a fair share of North American auto production. Continued rapid downsizing and higher efficiency in fuel consumption is absolutely necessary if the Canadian segment of the auto industry is to compete effectively with European and Japanese imports in the North American market.

Additional industrial initiatives will require:

- . Support for the private sector to underwrite developmental costs in the areas of:
 - renewable energy
 - public transit
 - instrumentation
 - district heating
 - rail electrification, and
 - auto parts technology;
- . There be an increased flow of risk capital to energy related industrial opportunities especially via the small business sector;
- . Special energy related R & D incentives be introduced; and
- . A significant Shop Canadian preference be attached to sourcing for major energy related capital projects, and discriminatory provincial procurement policies must be eliminated.

In terms of developing alternative energy sources, especially in the area of renewables, the business sector will also be expected to play a catalytic role. This will require substantial front-end funding to ensure that industry can develop the new technologies necessary to ensure energy self-sufficiency.

The Ontario economy has entered an era of expensive energy and, along with the rest of the industrial world, is facing serious adjustment problems. Adaptation, however, is absolutely unavoidable and can be accomplished to the lasting benefit of society. The rules of commercial success are changing. Nevertheless, the industrial future of Ontario remains strong, if the adjustment process is effectively undertaken.

